PFP Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4FP
020 7400 1860

www.pfpg.co.uk

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In search of real money

"Osborne says iconic red budget box empty 'for years', keys lost"

- Bloomberg headline.

This will be our final Investment Commentary of 2010. We would like to wish all clients, prospective clients and readers a happy and healthy Christmas and a peaceful and prosperous New Year.

The authorities continue to try and paper over the cracks, but the mission is futile because the entire superstructure is rotten. Wholesale banking failure is now colliding inexorably with wholesale political failure. In the US, this has led to a messy compromise whereby expiring tax cuts are renewed, and matched by an extension of benefits payments. US equities greeted the news with their usual Pavlovian dinner-bell yelps of thoughtless enthusiasm, but the Treasury market reacted by collapsing. As well it might: America's soaring national debt outlook just got measurably worse. In the euro zone, by contrast, austerity is winning out against sanity. Ireland has just been forced to accept bail-out loans from its European masters that represent, in effect, stealth support for their own ailing banks. Two systems, two different approaches. One common aspect: if bondholders weren't already feeling nervous about the outcome, they should be now.

Conventional economists continue to bicker about how we got here, and how we might get out. Keynesians and neo-Keynesians continue to indulge in a fruitless dialogue of the deaf; massive spending hasn't worked yet – evidently we just haven't spent enough. But for Austrian economists, the route map of the way here has always been clear, just like that of the directions for the way out. We got here because banks and central banks inflated a credit bubble that distorted economic activity and triggered colossal malinvestment, particularly in property. When that bubble burst, instead of simply getting out of the way, government intervention in the market perpetuated and intensified the impact of the bust. The Irish government has been roundly criticised for the blanket guarantees it issued to its banks in the dark days of 2008, but the British government hardly covered itself in glory. In return for saving its own bankrupt banks using taxpayers' money, the UK government managed to negotiate perhaps the worst deal in the world. By failing to nationalise insolvent banking groups completely, it maintained the myth that these organisations were somehow sound. More to the point, it managed to extract ***no control whatsoever*** over lending or any other policy decisions despite hundreds of billions in taxpayer support. Memo to self: try never to deal with bankers, and certainly, count your fingers afterwards.

If it seems that our current economic problems are uniquely caused by a confluence of politicians and bankers, it's because they are. These problems go beyond the quotidian concerns of property prices and the rate of economic growth. They go to the very heart of what Jörg Guido Hülsmann in his excellent book calls 'The ethics of money production':

"There is no tenable economic, legal, moral or spiritual rationale that could be adduced in justification of paper money and fractional reserve banking. The prevailing ways of money production, relying as they do on a panoply of legal privileges, are alien elements in the capitalist economy. [When commentators, watching in despair at the current crisis, write of a failure of capitalism, they should instead refer to a failure to allow capitalism to operate freely.] [Fiat money and fractional reserve banking] provide illicit incomes, encourage irresponsibility and dependence, stimulate the artificial centralisation of political and economic decision-making, and constantly create fundamental economic disequilibria that threaten the life and welfare of millions of people. In short, paper money and fractional reserve banking go a long way toward accounting for the excesses for which the capitalist economy is widely chided.. [Paper money and fractional reserve banking] have been created because ***they allow an alliance of politicians and bankers to enrich themselves at the expense of all other strata of society***." (Emphasis ours.)

Hülsmann, surely correctly, suggests that the monetary institutions of our time are in urgent need of reform. But as he also rightly observes, discussion of monetary reform, if it takes place at all, suffers from an amazing intellectual narrowness. This may be in large part because money is not a subject that we ordinarily ever discuss; we merely accept it. (But then, we don't always inhabit what feels like a now endless existential banking, financial and monetary crisis.) It may also be because conventional economists have a vested interest in maintaining the status quo. Again, to quote Hülsmann,

"Economists relish in pointing out the importance of economic incentives in the determination of human behaviour. While virtually no section of society has escaped their scathing criticism, until very recently few of them have been concerned about their own incentives. Yet the facts are plain: championing government involvement in money and banking pays the bills; promoting the opposite agenda shuts the door to an academic career. No consistent economist could expect monetary economists to lead campaigns against central banks and paper money."

Paper or fiat money alone is evil because it requires monopoly and coercion on the part of the state for its use. In the entire history of the world, no paper money has ever come into being spontaneously and been used by the public – it has always required government compulsion supported by a police state. And it is evil because, en route to an inevitable collapse in value, it invariably leads central banking institutions to inflate away the wealth of the citizenry – particularly when, as now, the banking infrastructure totters under a mountain of unsustainable debt.

Changing one's perspective, perhaps quite radically, on the essential nature of money (what it is, and what it is not) is not necessarily easy. But it is possible. As Andreas Acavalos has written so well:

"..the problem of economic calculation under a fiat monetary regime is fundamentally insoluble. It cannot be solved for exactly the same reason that you cannot solve the problem of "measuring" a length of cloth with an elastic tape measure. The only "solution" is to throw away the elastic and use a yardstick that cannot be stretched at will." That yardstick, of course, is gold.

"Since it is unfortunately not within our power, as ordinary citizens, to do away with fiat money, we have to live with it and manage our affairs accordingly; we must, in other words, take rational economic decisions in the context of an irrational monetary regime that distorts relative prices and renders them increasingly meaningless as guides of where to invest. Here, I think, is where the role of gold comes in: acquiring gold is not an investment. It is a conscious decision to REFRAIN from investing until an honest monetary regime makes rational calculation of relative asset prices possible."

In a world where all currencies are fiat, investing in currency is a sub-optimal decision; everything is relative. Gold and silver, admittedly, are closer to absolutes. But the US dollar for one is an elastic tape measure, and gold and silver are not.

We view the investible world through four asset class prisms: high quality debt; high quality equity; absolute return funds; and real assets. Three of these four types can be owned 'passively'; absolute return funds, on the other hand, are not a formal asset class as such, and positively require some form of active management. In the unrealistic circumstance of being forced at gunpoint to choose one and one only of these assets to hold for the foreseeable future, high quality equities, absolute return funds and real assets (notably gold and silver as "natural money") would all pass muster to a greater or lesser extent – but the exercise is in any case wholly artificial. On the matter of broader equity market valuations, we have no strong convictions – as always, we will stick to what we consider to be defensive high quality. But since the monetary authorities seem determined to print and debauch their way back to what they presume to be growth and wealth, that leaves a pretty serious question mark over having the entirety of one's investments concentrated in the form of bonds – or in the currencies in which those bonds are denominated. As the last week's price action in the largest (poorest quality) government bond markets would tend to suggest ("US stimulus sparks government bond sell-off" as the FT put it), investors in government bond markets like those of the US, the UK and even Germany may be in for a rude though not entirely unforeseen awakening.

Tim Price
Director of Investment
PFP Wealth Management
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Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

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